MONTHLY HOUSE VIEWS

April 2021

Showers for the bond market

As we begin the second quarter, **global equities are at record highs**. This milestone of optimism is belied, however, by **underlying angst, particularly in the bond market**. This angst has several veins. They include the extraordinary scale of central bank asset purchases and deficit spending; the rapid growth in money supply as households receive direct remittances from governments; overheating fears stoked by hopes that vaccinations will get economies back to normal; and the massive jump in commodity prices since last March.

These factors have prompted a scramble by investors to reassess inflation risks. Swap contracts on investor expectations of 5-year US inflation in 5 years' time have shot up from 1.22% last March to 2.41%. Contracts on Eurozone inflation have doubled from 0.72% to 1.49% in only 12 months.[1] **This dramatic shift in inflation fears has put downward pressure on fixed-income securities** as investors demand more protection against inflation, pushing yields higher (yields move inversely to bond prices). Ten-year US Treasuries currently offer a 1.63% yield, up from last April's 0.52% historical low – the Bloomberg Barclays index of long-dated Treasuries has registered a 18.6% loss since then. The yield of UK government Gilts has also risen, with the yield on 10-year issues rising from 0.20% to 0.80% over 2021. This equates to a year-to-date loss of nearly 7% for the FTSE UK Government Gilts Index (All). This downturn in bond markets has been one of the strong supports for equity markets.

Despite these shifts, central banks remained unperturbed. Last summer, the Federal Reserve shifted its priorities to focus on maximum employment – meaning it wants unemployment below the pre-pandemic lows – while indicating that it would be comfortable with a spell of inflation above its 2% target. This message was reinforced by policy-makers' March projection of no key rate hikes for the next three years. Similarly, the Bank of England stressed that little had changed in its medium-term outlook and it too was in no hurry to raise rates. Elsewhere, faced with tightening financial conditions, the European Central Bank (ECB) announced it would step up the pace of its asset purchases in Q2, which will help keep core bond yields low and periphery yield spreads tight.

Moreover, **we do not expect these inflationary pressures to last.** Current fiscal spending is designed to alleviate near-term problems for low-income households, the unemployed and businesses and will do little to enhance long-term growth prospects. This rapid money-supply growth has simply led to a build-up in savings, not an increase in velocity – the rate at which money circulates in an economy – which might be a harbinger of inflationary pressure. Furthermore, structural disinflationary factors, such as ageing populations and technology-driven productivity gains, have not disappeared.

Commodity prices will most likely fuel a spike in inflation in coming months which will keep bond yields under pressure, but we expect this to be a transitory phenomenon. Central bankers appear to agree and are likely to keep key rates unchanged, while enormous asset purchases will contribute to stemming any excessive upward pressure on bond yields.

Bottom line

We remain positively postured and are risk-on. As always, we are guided by the four pillars of our investment process:

- **Economic regime:** Our Leading Economic Macro Indicator (LEMI) suggests **the global economy is in a state of expansion, which is clearly favourable for risk-taking.**
- **Valuations:** Valuations for equities – the largest source of risk and return in most strategies – remain challenging in absolute terms, particularly in the US, which remains the most expensive global region. Heightened valuations – particularly in "large-cap, secular growth" companies – have been further

[1] Source: Factset. Data as at 14 April 2021.

challenged by increased inflation expectations, which raises the spectre of rates rising. However, **we believe central banks have little appetite to raise rates at present and inflation is likely to remain subdued over time, albeit a transitory rise may well occur.** Moreover, while government bonds yields have surged, they still are unattractive relative to equities. For these reasons, **we remain tolerant of higher global equity valuations at the headline level, but are tilting our exposure towards cheaper, more cyclical regions**.

- **Momentum: Global equities are in positive momentum** versus their ten-month moving average. This is supportive of increasing exposure to the asset class.
- **Sentiment:** Sentiment has turned more bullish on our underlying indicators. One in particular, Global Equity Fund Flows, shows huge inflows into global equity funds (and away from fixed income funds). Given the idiosyncrasies associated with the market's re-evaluation of inflation and the impact on bonds, this is understandable: It is more a function of the market's rational reaction to central bank policy rather than a signal for complacency or unjustified risk preferences as would be the case in more normal times. Nonetheless, **we remain watchful of our sentiment metrics.**

We believe the case for risk-taking is well supported given a strengthening economic backdrop and strong momentum. Nonetheless, we are wary of expensive valuations and over-bullish sentiment. On Balance, we are moderately risk-on with a continued preference for equities, but have been tilting more towards cheaper, value-oriented regions. We also continue to hold a stable of safe-haven assets, including gold, low-volatility, defensive alternatives (e.g. hedge funds) and government bonds.

OUR ASSET ALLOCATION

The table below presents the latest conclusions of the KH Investment Committee

			Summary house views					
			Strong UW	UW	N	OW	Strong OW	Change since last KHIC
EQUITY		GLOBAL EQUITY				■		
		United States		■				
		Eurozone				■		
		United Kingdom				■		
		Japan				■		
		Emerging			■			
FIXED INCOME	SOVEREIGN	GLOBAL RATES		■				
		U.S. Treasuries		■				
		German Bunds		■				
		UK Gilts		■				
		EM Government Bonds ($)	■					
		Duration USD*				■		
		Duration EUR*				■		
		Duration GBP*				■		
	CORPORATE	US Investment Grade		■				
		Eurozone Investment Grade		■				
		UK Investment Grade		■				
		High Yield	■					
FOREX		EURUSD			■			-
		JPYUSD			■			
		GBPUSD				■		
		EM FX (vs. USD)			■			
ALTERNATIVE		COMMODITIES				■		
		Brent		■				
		Gold				■		
		ALT. STRATEGIES			■			
		L/S Equity				■		
		Event-Driven				■		
		FI Arbitrage		■				
		Global Macro		■				
		CTAs				■		

	Positioning	*Duration
O/W	Overweight	Long – 7-10 years
N	Neutral	Intermediate – 5-7 years
U/W	Underweight	Short – 3-5 years

Source: Kleinwort Hambros 12-April-2021

*Duration: short = Up to 5 years, medium = 5-7 years, long = 7+ years. HY = High Yield bonds (higher return but greater risks), IG = Investment Grade bonds (higher quality but lower return)

EQUITIES	
United States	We remain Underweight on US equities and stress the importance of diversifying into more cyclically-sensitive, undervalued sectors.
Eurozone	Eurozone equities resumed the outperformance despite a troubling vaccination rollout. We continue to be Overweight the region to take advantage of a cyclical recovery in H2.
UK	The rapid progress in vaccinations and a faster-than-expected economic recovery has bolstered business confidence and the UK ranks as the cheapest major market. We remain Overweight
Japan	Japanese equity markets recovered swiftly from a turbulent month of trading in March. Momentum remains positive and valuations reasonable. We are Overweight.
Emerging (EM)	Throughout March, EM equities struggled with volatility resulting from US yield rises and cyclical rotation. However, valuations remain attractive and we are Neutral.

FIXED INCOME	
Sovereigns	Government bonds reclaimed some of their core benefits – namely protection and income – following the recent surge in yields but we remain Underweight.
Duration*	We retain a medium-to-long duration position across most portfolios as a bulwark against wide volatility in risk assets.
Investment Grade**	Investment Grade credit spreads should remain low, helped by central bank purchases. We remain Underweight.
High Yield**	High Yield bonds remain more vulnerable to the economic challenges, especially the weakest issuers. We are Underweight.
Emerging debt (in $)	While the yield on offer is compelling, we do not feel it warrants the credit risk that EM issuers carry. We are Underweight.

CURRENCIES	
EUR/USD	The single currency remains undervalued; however, it will be an uphill struggle until the vaccine rollout picks up in Europe.
GBP/USD	Sterling profits are being taken as lockdown easing begins, and now negative rates look less likely in the UK.
EUR/GBP	This currency cross is overdue a correction to the upside, considering the recent run in the pound.
USD/JPY	The dollar looks overbought versus the yen after a sharp rally in recent months.
Emerging	We expect the renminbi to consolidate in coming months before heading higher again.

ALTERNATIVES	
Hedge funds	We prefer strategies which can hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short.
Gold	Gold prices have unequivocally entered negative momentum as rising yields eroded its attractiveness as a safe-haven asset. We reduce our allocation but remain Overweight given ongoing diversification benefits.
Oil	We expect oil prices to trade sideways in coming months at best and have no direct exposure.
Income producing Alts.	Attractive opportunities exist in infrastructure, selected real estate and specialist lenders for Target Return and income-focused strategies.

Source: Kleinwort Hambros 12-April-2021

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**HY = High Yield bonds (higher return but greater risks); IG = Investment Grade bonds (higher quality but lower return)

FIXED INCOME

Facing challenges

Today's environment of reflating economies and soaring debt issuance to finance fiscal largesse presents a challenging backdrop for fixed income markets. Our allocations are unchanged, remaining Underweight in both sovereign bonds and "credit" (i.e. investment grade (IG) and high yield (HY) corporate bonds).

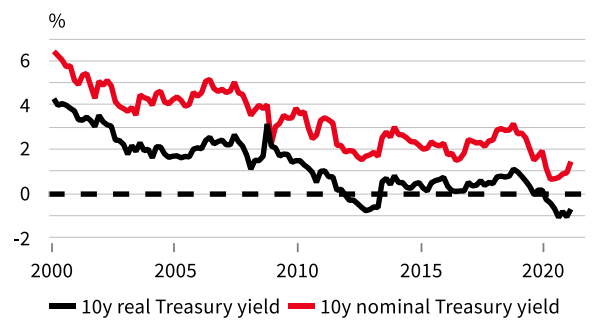
Sovereigns

US. Inflation expectations have soared fuelled by commodity prices, rapid easing of lockdown restrictions and massive fiscal spending, pushing bond yields up to their highest level since February 2020. Further upside is possible, especially if President Biden's $3 trillion green infrastructure investment plan gains traction in Congress, given the massive bond issuance this would likely entail. However, we expect any spike in inflation to prove transitory and as a result, the bulk of the downswing in bond prices is likely now behind us.

UK. Since December 2019, 10-year UK sovereign ("gilt") yields have swung from 0.79% to historic lows at 0.08% and back to 0.75%. (Source: Factset as at 14 April 2021) Like the US, the UK has made rapid progress in vaccinations, enabling the government to progress on their roadmap to ease restrictions and raising fears of a spike in inflation later this year. However, the Bank of England (BoE) shows no inclination to tighten policy as it still sees little overheating risk on the horizon.

Eurozone. In comparison with Treasuries and UK gilts, upside in core Eurozone bond yields has been rather modest – 10-year German ("Bund") yields rose from -0.57% in early January to -0.23% in late February before easing back to -0.33% in April. Source: Factset as at 14 April 2021) There are several explanations for the reluctance, including a possible third consecutive quarter of recession in Q2 following slow vaccine roll-outs and a likely resulting third wave in COVID-19 infections. In addition, the ECB recently stepped up the pace of its enormous €1.85 trillion asset purchase programme. With such low yields on offer, we remain Underweight.

10-year US Treasury yields are up



Source: SGPB, Macrobond, 25/03/2021

Credit

US. Yields on IG bonds have tracked those on Treasuries higher since end-December, leaving "spreads" (i.e., yield differentials) at only 195 basis points (bps; companies rated BAA), close to all-time lows. This leaves limited room for further spread-compression and we remain Underweight. In addition, speculative-grade HY bond yields at 4.34% offer little compensation for the continuing elevated default risk and we remain Underweight.

UK. There is little more value in sterling-denominated credit. IG spreads over gilts have risen a meagre 7bps from mid-February's record low and GBP HY yields are only marginally above recent all-time lows. Such valuation levels reflect the BoE's accommodative stance and the looming cyclical recovery as restrictions are wound down, but further gains are unlikely. We remain Underweight.

Eurozone. At only 0.17%, yields on euro IG bonds remain deeply unappealing given core inflation at 1.1% in February. The ECB's accelerated asset purchases over the next quarter will prevent much downside in prices but such low yields offer little prospect of capital gains. We remain Underweight.

Emerging debt

Among global sovereign bond markets, EM issuers stand out with spreads over US Treasuries of 320bps. Despite rising US yields and a stronger dollar, EM debt markets have held firm, no doubt aided by robust growth led by China and improving fundamentals. Nonetheless, we do not feel the spread warrants the credit risk that most EM issuers carry and we remain Underweight.

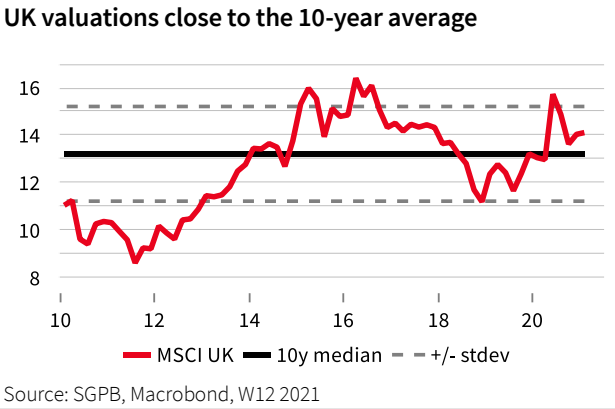
EQUITIES

A bull's birthday

One year on from their trough on 23rd March 2020, global equities have gained an astonishing 83%. While valuations are stretched – to say the least – the macro backdrop remains supportive and investors should rebalance portfolios towards more cyclically-sensitive markets to take advantage of the roaring economic recovery.

US. Large-cap US equities reached new all-time highs in mid-March and remain close to those levels. However, this masks a marked rotation which has seen Growth sectors like Information Technology lag Value stocks in areas such as small caps, Industrials and Materials. One of the key triggers has been the surge in bond yields – when long-term growth in a company's cash flows is discounted using higher rates, the net present value of its earnings comes under pressure. It is no surprise therefore that periods of rising rates often see established Value players – where cyclical cashflow increases offset the higher discount rates – outperform Growth names whose profits may be projected into the far future.
We remain Underweight Growth-biased US exposure in favour of opportunities in other regions.

UK. The UK's rapid progress in vaccinations has bolstered business confidence - March's composite purchasing managers' survey surged to 56.4 from 49.6 in February - and analysts have upgraded 2021 earnings forecasts by almost 6% over the past 3 months to 48.3%. In addition, higher-than-expected GDP growth suggests an economy rapidly adapting to new circumstances – a promising assessment for a region facing challenges from both a global pandemic and a tectonic shift in trade environment. Nonetheless, the UK ranks as the cheapest of the major markets we follow, trading at 13.7 times forward earnings, a modest 4% premium to the average over the past decade. Thus, we are Overweight.



Source: SGPB, Macrobond, W12 2021

Eurozone. The EU has suffered numerous procurement and delivery problems which have hampered its vaccine rollout, leaving the region vulnerable to yet another wave in coronavirus infections. As a direct consequence, lockdown restrictions have been tightened and extended, further delaying a genuine economic recovery. However, with a new vaccine becoming available in April and further deliveries on the way, we are confident that H2 will see a robust pick-up in activity. Investors appear to be looking ahead to the recovery, which has helped Eurozone equities resume their outperformance vs the US. We remain Overweight.

Japan. The Bank of Japan recently revised its asset purchase guidelines, shifting its focus for equity ETFs from the Nikkei 225 index to the more representative Topix, which gained 8.4% since the start of the year. Japanese stocks are well-placed to take advantage of robust growth across Asia-Pacific, earnings forecasts are being revised higher and valuations are rather reasonable at 17.7 times forward earnings and a 1.9% dividend yield. All in all, we remain Overweight.

Emerging Markets. Analysts are continuing to revise earnings forecasts higher, in particular in laggard markets like Brazil and Russia, and valuations remain relatively attractive. However, Asia's resilience in the face of the pandemic means that there may be less cyclical upside there than in markets like the Eurozone and the UK, while dollar strength often proves a headwind for EM. We remain Neutral.

Global Opportunities. We see increasing value in Environmentally-focussed equities across the globe. This allocation seeks to take advantage of what we consider irreversible trends in environmentally-linked policymaking, legislation and consumer behaviour. As a result, we will be investing in companies at the forefront of natural resource efficiency (e.g. renewable energy, energy efficiency, sustainable agriculture and forestry) and the protection of ecological integrity (e.g. water support and technologies, waste management and recycling, as well as pollution control).

CURRENCIES

Slow path back to normality

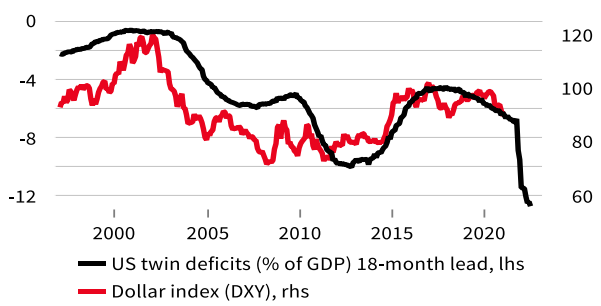
The US dollar was sharply oversold in early January and has now corrected back to last autumn's levels. In the second half of the year the US dollar is likely to soften further. However, for now we expect sideways trading until there is more clarity on a cyclical recovery.

Dollar Index. The dollar index has steadily strengthened since the lows seen on 5th January this year. The timing coincided with the Democratic victories in Georgia handing control of Congress to President Biden, who has since embarked on massive fiscal spending, raising growth and inflation expectations and widening yield differentials in favour of the greenback. The strength may persist in the near term; however we expect the dollar to weaken again in the second half of this year.

EUR/USD. EUR/USD is undervalued according to multiple measures; however, risk sentiment is not on its side. The vaccination rollout in some of the major European countries has been muddled, and many countries, including France and Italy, are experiencing a third wave of the virus. The US dollar on the other hand has been robust, supported largely by rising bond yields and hopes of a faster economic recovery than expected. The 1.1700 level may well be the bottom for now, but we have lowered our second quarter forecast to 1.2000 in order to reflect our cautious view.

GBP/USD. Moves in GBP/USD over the past few weeks have been much more erratic as March saw Cable trading both above 1.4000 and below 1.3675. The UK's lockdown-easing roadmap is on track, which, if successful, should accelerate its economic recovery. Negative interest rates are being priced out by the market, further supporting the pound, and we will likely see some profit taking in the weeks ahead. However, we still expect a gradual grind higher from current levels and have revised up our forecast accordingly to 1.3900 for the next quarter.

Twin deficits should weaken the dollar index



Source: SGPB, Macrobond, BEA, U.S. Dpt of Treasury, 25/03/2021

EUR/GBP. This cross is little changed since the start of March. Despite being oversold according to momentum indicators, the cross has traded mainly between the 0.8500 and 0.8600 levels over the last month. EUR/GBP has recently appreciated; however, we don't expect this recovery to be long-lasting, and our forecast remains flat at 0.8633.

USD/JPY. The dollar looks overbought after a rapid rally from 103 in early January to over 109 in late-March. In part, the move reflects optimism on US fiscal spending and reflation, which has widened Treasury yield differentials vs Japanese Government Bonds. In response, the Bank of Japan has widened its yield curve control range on 10-year bonds from +/- 5 basis points (bps) to 25 bps around 0%. Looking ahead, we forecast USD/JPY to marginally consolidate below current levels but expect increased volatility.

EM currencies. JP Morgan's index of emerging currencies has pulled back from mid-February's 12-month high as rising dollar rates have eaten away at investor confidence in EM currencies. Historically, such episodes have put pressure on emerging borrowers' ability to service their dollar-denominated debt obligations. However, the pandemic has helped improve many countries' current account balances: Indonesia and India have swung into surplus for the first time in a decade. Further, global investors have shifted away from weak links like Turkey where the bulk of foreign-currency bonds are held by domestic corporations and households. Overall, EM currencies should trade sideways for now.

USD/CNY. The US-China summit in Alaska in mid-March, the first involving the Biden administration, was marked by sharp rhetoric on both sides of the table. As we expected, the new president has decided to keep a hard-line stance on bilateral relations. This suggests that Beijing may see less need to let the CNY strengthen against the dollar; a move which has helped alleviate trade tensions since last summer, and instead let the currency trade in a range for now. Notwithstanding such considerations, investment flows into China should continue given the attractive real yields on offer.

ALTERNATIVES

Heading for a fall in real yields

We expect oil prices to consolidate in coming months as supply cuts compensate for sluggish near-term demand. Gold prices should stabilise once real rates fall again. We prefer hedge fund strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short.

Commodities

Oil

After touching $70 per barrel in mid-March, Brent oil prices have registered their first significant correction since November's vaccine announcements. A flurry of tightened lockdown restrictions across Europe in recent weeks have led analysts to factor in an extended period of reduced mobility, hitting motorists' petrol consumption. We don't expect there to be much downside in prices however – OPEC and its allies (OPEC+) are maintaining supply discipline, having postponed this month's planned 500,000 barrels per day (b/d) increase in output; and US production is still over 2 mb/d below last March's levels.

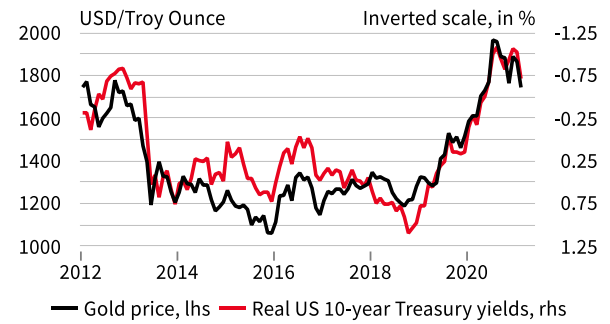
Looking ahead to H2, we expect oil demand to recover across advanced economies as the Eurozone exits recession and seasonal demand in the US kicks in. However, this should coincide with increased supply – Saudi Arabia is likely to unwind its voluntary 1 mb/d cuts; US shale fields will be able to increase output given higher prices; and more Iranian oil could find its way onto the market if US sanctions are eased (already, China is importing 1 mb/d in defiance of the embargo on Tehran).

We continue to see Brent trading between $60 and $70 in the coming months.

Gold

Central banks made small net sales of gold in January, led by Turkey, which is facing severe currency volatility. Gold ETFs saw outflows in February amounting to 84.7 tonnes (t), some 2% of their total holdings, as prices slipped on the back of rising bond yields. As a non-interest-bearing asset, gold looks relatively less attractive when real rates (i.e. rates after inflation) are rising, as they have since early August when gold hit its all-time high within 48 hours of 10-year Treasury yields hitting their all-time low.

Gold prices should stabilise once real rates fall again



Source: SGPB, Macrobond, BLS, LMBA, 25/03/2021

Early signs of a pick-up in physical demand for gold continue to emerge. Official Indian imports hit a 21-month high of 91t in February, boosted by lower domestic prices and rising purchases ahead of the wedding season. In China, retail gold consumption boomed in February during the Lunar New Year holiday, which should lead to a rise in wholesale demand in March as retailers replenish stocks.

Looking ahead, the impending spike in inflation should again put pressure on real yields, which should help support gold prices.

Nonetheless, gold remains an effective diversifier with a low correlation to equities. Indeed, it tends to be negatively correlated when equities are under heightened selling pressure. This is an important consideration for why we continue to hold it, albeit at a reduced position from where we started the year.

Alternative investment strategies

Hedge funds: Prefer Merger Arbitrage type strategies

Hedge funds can help in unstable market conditions, but selectivity is key. We prefer strategies which hold their own in bear markets, such as Merger Arbitrage, trend followers and Equity long/short. These strategies provide relatively safe, uncorrelated sources of returns from equities, our most significant allocation across balanced and growth multi-asset strategies and provided positive contributions to returns – and lowered risk – especially during periods of volatility. In the market volatility in 2020, our hedge fund selections all held their own and performed well.

Income Producing

In Target Return strategies, we are exploiting several niche investment opportunities in selected real estate (e.g. medical centres, student accommodation), infrastructure and specialist lending (e.g. pharmaceutical royalties, economic infrastructure).

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